J.S. DEPARTMENT OF COMMERCE
Under Secretary for International Trade

February 21, 1984

To: Maurice Ernst

From: Lionel H. Olmer

I think the attached may be of interest to you.

Attachment

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UNITED S..TES DEPARTMENT OF COMMERCE
The Under Secretary for International Trade
Washington, D.C. 20230

FEB 21 1984

Mr. A.W. Clausen
President
The World Bank
1818 H Street, N.W.
Washington, D.C. 20433

Dear Tom,

I read with great interest your Davos speech on the "Priority Issues for 1984." I agree that we are far from the end of developing country debt problems and that it will take many years to repair the damage that has already been done.

You point to four economic issues that deserve priority attention in 1984 -- improving economic policies in industrialized countries, trade liberalization, reviving international capital flows, and improved economic policy in developing countries. Some progress has been made in improving economic policies in developed and developing countries. However, it is in the areas of trade liberalization and reviving international capital flows where I most share your concerns.

The link between trade liberalization and increases in financial flows has been discussed at some length, but in my view the focus has been primarily on a trade/finance "link" -- which has usually been interpreted to mean that trade must adjust to make up for any financial shortfalls. A more appropriate focus should be on a trade/finance balance where the amount of financial adjustment is weighed against the need for a prudent and sustainable trade adjustment. This would ensure that excessive pressures are not placed on developing country trade accounts.

The sharp contraction in imports seen thus far, if continued, threatens to prevent debtor countries from recovering and servicing their debt. Sharp shifts in trade (e.g., a 500% surge in one year in steel shipments to the U.S.) also increases pressure on the trading system which will make it more difficult to achieve the trade liberalization all agree is necessary.

It's clear that you recognize the importance of trade expansionary adjustment to developing country debt problems. You note the benefits to developed and developing countries of the adoption of market-oriented and outward-oriented development strategies. However, it is these very policies that are threatened by financing shortfalls. You note that since 1981 countries have increasingly adopted import restrictions to cope with balance of payments problems. However, you seem to expect that developing countries will again be able to import more than they export as private lending increases.

I am not as sanguine. My staff is in the process of completing detailed analyses of the trade outlook for several high-debt countries. These analyses look at the likely development of the export sectors in high-debt countries given their current import and capital constraints and the outlook for growth in global export markets. While the data are still preliminary, we conclude that financial constraints and slow export expansion will require any trade surplus to be achieved primarily from continued import constraints through 1987. This is quite different than the expectations many hold for high-debt countries and for resolution of their debt problems. As these studies are completed over the next several weeks I will make them available to you for comment. In the interim I think it is important that we begin to review ways to prevent these trade contractions from continuing. Let me review in some detail the reasons I think this is necessary.

My concern is primarily with the way macro financial problems have affected the micro world of financing for trade. With the onset of liquidity crises in developing countries, central governments, large banks, the IMF, the Treasuries and Central Banks of developed and developing countries immediately joined forces to provide liquidity for balance of payment purposes. In the midst of this, what was overlooked were the private financing lines normally used to maintain trade flows. The reduced levels of foreign exchange resulted in payments moratoria, reschedulings of short-term trade credits and centralization of access to foreign exchange that has had a chilling effect on trade and the mechanisms through which trade is financed.

For example, we estimate that over half of our trade with Latin America used to be conducted through open account transactions. That is, U.S. exporters were shipping to importers in those countries without the benefit of bank or government guarantees. That type of open account financing has virtually dried up. Secondly, multinationals which provided unsecured financing for their affiliates and even for some non-affiliates substantially reduced their lending when it became obvious that the "short-term" liquidity crises in these countries would require a long time to work out. Finally, banks under pressure from stockholders and regulators have been attempting to reduce their exposure to developing countries. Forced to lend as part of an IMF adjustment program, they have been reluctant to increase or even maintain other types of lending -- primarily trade financing for private firms and interbank lines.

The result of all this is a dramatic shift in the way trade is conducted which will likely hamper attempts to achieve the type of longer-term, market-oriented adjustment which would most effectively resolve debt problems. Let me give you some examples:

In Mexico during the period from January-November 1983 (at a time when Mexico was achieving remarkable "success" in reaching its adjustment goals) imports dropped about 50% below the targets planned as part of their IMF programs. This could cut into Mexico's ability to restart its economy and to reach a productive export-led recovery. Perhaps more importantly, private sector imports dropped 64% from 1982 levels while public sector imports declined by only 21%. This type of reliance on state run enterprises for economic growth has led to the inefficiencies and large public sector deficits that have increased financial problems in many developing countries.

These trade contractions also affect U.S. exporters, both because of the loss in sales and also because payment for past exports go unpaid or are rescheduled, resulting in liquidity problems for U.S. firms. Over the last two years U.S. exports to Latin America alone dropped by $17 billion -- equal to about 400,000 U.S. jobs. At the same time, imports from Latin America have increased by $3 billion. However, here the Latin exports have not come through export diversification but primarily in products which they could quickly supply to increase export earnings, e.g., steel, copper, footwear. The surges in our imports from high debt countries in these sensitive areas at a time when U.S. exports are dropping sharply is not the type of climate conducive to trade liberalization. This is not to argue that trade adjustment is not needed, just that the pace of the adjustment may be counterproductive.

Let me illustrate what these trade and trade finance contractions mean for the broader trading system. First, we are seeing a rapid increase in countertrade, clearing arrangements and other forms of non-hard currency transactions. The interest is not solely on the part of developing countries but also by U.S. firms who see these mechanisms as ways to maintain markets where financing is no longer available.

Secondly, there has been an increasing desire to use Eximbank resources to fill these financing gaps. This is something we have supported as we felt the crisis environment required steps to help reestablish confidence in trade finance lines. However, this approach is also not without its perils -- as critics have recently pointed out. The budget implications have become important as reschedulings and increasing risks in lending to developing countries have added to the actual costs and potential costs of Eximbank cover. Also, trade officials in other countries have suggested that our willingness to use Exim to fill financing gaps is veiled "mercantilism" which would lead to a bilateralization of trade. And, there is the ever present "moral hazard" when public agencies cover private risks -- how can we ensure they do not replace private lenders? Despite this risk, or perhaps because of it, we continue to receive numerous suggestions by banks and exporters on how to expand the use of U.S. government export credit facilities.

These approaches, from countertrade to Exim cover, are simply ways to try to reestablish prudent levels of trade at a time when financial constraints prevent this trade from going forward. You may be assured that there will be growing pressure to use these methods as long as financial constraints continue, and the continued use of these methods will create increasing problems for attempts to improve the trading system. That is why in my view, one of the priority issues in 1984 must be how to reestablish more prudent levels of financing for trade.

We are reviewing this issue at the micro-level to see how we can get trade financiers to reestablish lines of credit. However, the issue also has to be addressed by those setting policy at the macro-level. As long as foreign exchange priority goes first to banks for interest and next to the public sector, there will be nothing to ensure exporters that their credit to importers will ever be repaid. At the macro-level there needs to be a rethinking of the priorities on foreign exchange use -- perhaps there is some amount of export earnings that ought to be reserved for import needs and insulated from other uses or from the threat of reschedulings. Maybe we need to develop more innovative ways to ensure that private capital flows reach the productive elements of these economies. Might there be a way to draw a fence around the trade finance necessary to support trade or investment in a given region, or for an industrial sector, or a specific project?

If none of these is possible -- and if we are instead faced with inevitable foreign exchange shortfalls for the next several years -- perhaps we will need to allow or even facilitate non-hard currency transactions. However, if that becomes necessary the trading system should not be alone in being asked to approve these transactions. Again a trade finance "balance" would suggest that banks and investors could put non-hard currency payments to use, at least until we return to a time when adequate foreign exchange for prudent and sustained economic adjustment is again available.

I apologize for the length of my response to your speech -- I hope it will not discourage you or your staff's attention to this or to the enclosed speech I gave on the same subject. I look forward to your reaction to our analysis and suggestions.

Sincerely,

Lionel H. Olmer

Lionel H. Olmer

Enclosure

"New Directions in Trade Finance"

An Address By Lionel H. Olmer
Under Secretary for International Trade

U.S. Department of Commerce

Before the Financial Times Conference:
"BEYOND THE DEBT CRISES: NEW DIRECTIONS IN WORLD TRADE"

Washington, D.C.

January 24, 1984

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This audience doesn't require an extended lecture on the roots of current debt problems. The heavy borrowing by developing countries during the 1970's due to meteoric increases in the cost of imported oil, followed by rapid rises in interest rates and sharp declines in export earnings brought about by global recession, are widely understood to be the precipitating incidents to the financial crisis which today grips many nations. The task is not to debate history, but to peer towards future directions of world trade.

There is not much room for overconfidence about the future -- it's much easier to play Cassandra. A successful outcome is not, by any stretch of imagination, inevitable. But I am optimistic because the stakes are so high for all of us that I believe we will work together effectively to resolve long-term developing country debt and trade problems by having all parties collaborate in equitably distributing the hardships of adjustment. This will involve three key elements:

- Continued reform of developing country economies at a steady pace, under the guidance of the IMF;

- Sustained, non-inflationary economic growth in the developed world that generates open and growing markets for developing country exports;

- Renewed net capital inflows from all of the sources upon which developing countries have traditionally relied; this includes:

  -- bank loans and guarantees which support trade and help to meet other financial needs;

  -- credit from what might be called "non-banking institutions," ranging from small and medium-sized exporters to the major multinational companies;

  -- financial assistance from official sources, including bridge loans and trade financing packages;

  -- direct equity investment in the developing country economies by the private companies of the industrial world; and

  -- an end to the flight of capital from the developing countries.

Integrated approaches, I grant, have not been frequent occurrences in resolving complex international problems. But it is the most promising path -- perhaps the only one -- for restoring economic stability and trade . Consequently, let me describe how far I think we have come in the last several months and then assess how far we have to go.

There is some reason for cautious optimism. Widespread debt, trade, and financial problems in the developing countries have not led to the collapse of the world economy, as some have feared. Despite the traumatic events of the past one and one-half years, relative order has been maintained and good news has emerged on several fronts:

- The developing country economic adjustment process is underway. The most notable success story is Mexico--where the recent wave of Latin American debt crises initially began in August 1982. Through skilled handling of the situation by President de la Madrid and his new government, Mexico has thus far achieved a sharp turnaround in its external accounts. Apart from Mexico, other developing country governments have also begun to implement reform and austerity, and have expressed an intent to continue these measures.

- A robust U.S. economic recovery is being experienced, and its momentum is spreading throughout the member states of the Organization for Economic Cooperation and Development (OECD). This will increasingly have a positive affect on the export earnings of developing countries.

- We are also encouraged by indications that developing country governments and commercial bankers are taking "nuts-and-bolts" trade credit issues more into account when formulating new borrowing requirements. Initially, responses to developing country debt problems focused on macro-financial implications, especially for the world banking system and the impact of a failure to meet interest payments. Little attention was paid to trade financing issues. It is heartening to see a growing recognition of the complex linkage between finance and trade, and the need to address all aspects of developing country debt problems.

However, despite these hopeful signs, the fact remains that recent efforts by some developing countries' to obtain new capital inflows have had disappointing results. For instance:

- The most recent data collected by the Bank for International Settlements reveal that bank lending to developing countries increased by only $4.7 billion from end-1982 to the end of June 1983. This compares with a growth of $17 billion for the first-half of 1982. Gross bank lending to Latin America increased by only $3.7 billion in the first half of 1983 vs. a $33 billion increase in 1981 and an $18 billion increase in 1982. While these earlier levels may have been excessive, this recent sharp contraction makes difficult a sustainable adjustment program, particularly as interest payments to many countries have more than doubled since 1979 figure.

Despite a modest improvement in the developing country trade credit picture since last summer, the performance of banks in this area is still cause for concern. Six months ago, I pointed to several problems which persist to this day:

- o Banks continue to maintain a tight rein on medium-term loans that directly support exports to developing countries. Of course, the banks argue that they have had to grant new medium-term loans to enable developing countries to meet interest payments on past loans. As a result, many banks have sought to reduce medium-term lending for other purposes, including loans promoting the sale of capital goods.

- o Banks, exporters and multinational corporations continue to limit their developing country trade activities to transactions involving an absolute minimum of risk. Although many large companies and sophisticated U.S. exporters are once again extending some credit to certain developing countries, most small and medium-sized U.S. companies have cut their exposure throughout the developing world.

- o Many business transactions in debt-ridden developing countries are still excessively time-consuming and difficult to complete because of demands by banks, exporters and multinationals for both collateral and for detailed documentation. The net result is a chilling affect on potential trade.

- o The secondary market for discounting developing country trade paper remains crippled and this limits the ability of exporters to finance accounts receivable or to divest themselves of this trade paper. The result in most cases, has been increasing reluctance by exporters to grant short-term credits on their own account.

- o The private sector in debtor countries is bearing the brunt of the adjustment as it is often viewed by outsiders as representing the greatest credit risk because access to foreign exchange is controlled by the central government which provides the public sector easier access to credit or cash. What an unfortunate irony, since in many cases it has been grandiose and ill-advised spending by public corporations in developing countries which accumulated the debt in the first instance! And it remains the private sector which stands the best chance of getting these economies moving again.

- o Perhaps most fundamentally troubling of all is that the developing country debt of about $700 billion means these countries will face a heavy debt service burden for years to come. Depending on assumptions about interest rates, the cost to developing countries in 1984 for servicing their debt may approach $90 billion. The prospect then is for sustained and severe pressure on the trade accounts, as a large share of export earnings continues to be diverted to debt service.

In 1983, for instance, debt service costs borne by Mexico, Brazil and Argentina were equal to about 50% of their combined 1983 export earnings. When one subtracts essential imports of food, and energy, which in some of these countries is substantial, it leaves very little for the imports needed to sustain economic activity. This is why continued capital flows are so critical for recovery in these countries.

In my view, the brunt of developing country economic adjustment cannot be borne much longer by developing country trade accounts. The recent trade surpluses of key developing countries have been attained mainly through deep import cuts rather than export growth. This has contributed to recessions which undercut political support for the economic adjustment programs. Although developing country exports should pick up as demand increases in the industrialized world, there are indications that current low levels of developing country imports are impeding their efforts to pursue economic adjustment goals in an orderly way. Simply put, farm production will suffer if adequate levels of chemical fertilizers are not imported; or trucks and automobiles for export will be reduced in number and quality if necessary component parts are not imported. Even for countries like Mexico, where debt service costs will increase rapidly toward the end of the decade, expansion of exports is desperately required to avoid another round of debt problems.

Ideally, the adjustment programs should allow for a shift in resources to the export sectors. This would help increase the competitiveness of the exported products and probably diversify the export base. A rapid drop in lending to these countries prevents this diversification by denying access to necessary imports as well as to capital for required investment. And thus far, investment has been declining in almost all the high debt countries.

If countries attempt to meet export targets despite these constraints they may do so by selling whatever products they have even if they are in oversupply on world markets, sometimes with government help, or by sales below fair value, or by countertrade. Copper, steel and oil come to mind. This depresses the price of exports and fuels protectionist pressures.

Such trade distorting practices and rapid shifts in trade flows will inevitably lead to calls for managing markets and restraint on imports. A quick look at the growing numbers of bills pending before the Congress which have a decided protectionist coloration, and the growing number of requests by domestic manufacturers for trade protection, drives this point home.

Over the last two years, the U.S. trade balance with Latin America shifted by $20 billion - a $17 billion drop in U.S. exports affecting as many as 400,000 U.S. jobs and a $3 billion increase in our imports. This is the largest shift in history in our trade balance in so short a period of time.

These developments and trends make it evident that despite some progress at coping with developing country debt problems, there is yet a long way to go.

If this, then, is where we are now, what does the future hold? What new directions should we pursue in seeking to reestablish trade? Can we be innovative and increase trade without protectionism, or will these new directions result in cumbersome trading mechanisms that are nothing more than panicked reactions to a deteriorating environment for normal commerce?

Last fall, the Commerce Department hosted a meeting between U.S. banks, multinationals, exporters and other members of the Administration to review problems in trade finance and investment in high-debt countries. We asked participants to give us their views on how to deal with these problems. Let me briefly summarize some of these ideas:

They suggested that ways be found to reduce the risks and delays in Exim or private bank lending, by enabling the foreign borrower to pledge future export receipts to repay the loan; by collateralizing loans with warehouse receipts of products actually shipped to the U.S., to include strategic materials which Exim or private banks would use to cover risks; and by having the Exim increase its coverage of interest payments in return for the private banks absorbing more risk on loan principal (this would be designed to prevent bank loans from being classified as "non-performing").

We have also had suggestions on how to facilitate trade without the direct use of dollars--either through clearing arrangements as many debtor countries are doing at present, or by setting up mechanisms for use the of local currencies. For example, allowing overdue payments for past imports or interest to be credited against purchases of goods in the debtor country, or against capital investments in the debtor country.

Since investment flows are critical to developing country recovery, the idea that such payments be used as a credit on new investment, deserves most careful consideration.

Finally, there has been the repeated suggestion that the U.S. exchange agricultural goods for strategic materials -- thus removing the need for any scarce hard currency to change hands.

These trade facilitating ideas begin to touch on the subject one of your panels will discuss later this afternoon -- "Government Policy Towards Unconventional Trade Financing".

Countertrade

Under present conditions, increased use of countertrade techniques appears attractive for cash-short developing countries as well as for their industrial country business partners. For developing countries, countertrade is seen as a way to obtain imports that they cannot otherwise purchase. Countertrade might also be seen as a way to increase exports of commodities facing stiff competition and to free-up developing country cash reserves which could be used for other purposes; for example, to meet debt service payments.

I recognize that an increasing number of countries have endorsed or encouraged countertrade arrangements and that the likelihood of the trend continuing is high. Other compensatory arrangements are also seen as a way to facilitate exports in foreign exchange-poor markets. For example, the Government of the Philippines recently issued guidelines to allow some firms to convert their import costs into foreign-owned equity. The goal here is to reduce the net outflow of foreign exchange by means other than countertrade.

Unless we can reestablish normal trade finance facilities it is this broader category of "compensatory transactions," rather than just countertrade, that will most likely expand. In the interim, for some companies wishing to do business in developing countries, these arrangements appear to offer the only real hope for making a sale or for maintaining or expanding market share.

The reality is that many will be tempted into these transactions, or will be required to by the importer or its government; thus, the International Trade Administration's Domestic and Foreign Commercial Services are preparing to provide advice and market intelligence. But be wary: it's a very complicated business, easier to lose at than win, as measured by the experiences of those we've talked with.

One problem with countertrade is that you have to work twice as hard to complete a deal. First, you have to sell your product; and then you have to sell your customer's. If you're prepared to do this--and it appears that many companies feel obliged to--we have some knowledge and experience we can share. However, exporters should understand that we view countertrade arrangements as contrary to the efficient conduct of international trade. We are particularly opposed to Government-mandated countertrade, which directly subverts the free market principles to which all OECD member governments subscribe.

Over the long term there is a real danger that countertrade could weaken a developing country's export competitiveness. This seems to be the case in Eastern Europe, where countertrade has gotten a big push in recent years. Initially viewed as a cure for Bloc country hard currency shortages, it has not resulted in any increase in the competitiveness of East European products. Countertrade is no substitute for a dynamic export capability that emphasizes quality, and reliability.

There are two general directions in which trade will evolve: (1) Towards these apparently innovative but cumbersome and inefficient mechanisms; or (2) Towards the reestablishment of normal trade finance. This latter objective, by far the preferred course, will require a renewed commitment by all the key players. Banks, exporters, and governments on all sides must contribute, if this is to happen. Let me review what this entails:

Bank Lending

- Reductions in bank credit have intensified the pressure on developing country trade accounts. Banks point out that they in turn are faced with pressure from stockholders and bank boards to scale back their exposure in these countries. This is understandable from an individual bank's perspectives, as some have multiples of their capital in loans outstanding to developing countries. However, insufficient lending is just as unsound as wide-open lending. Loans made before adjustment programs were in place were perhaps less prudent then those that can be made now that some countries are on the road to adjustment.

  Sound international banking requires that lenders differentiate between different countries and regions; not all developing countries deserve to be tarred with the same brush. And even within "problem" countries, there are solid private-sector borrowers that have good future prospects. If debts are to be repaid and trade reestablished, there must be adequate foreign exchange for essential imports and for recovery of the private sector.

- Banks have been criticized for the high interest rates and fees that they are charging developing countries on new loans. Critics point out that these costs only increase developing country debts and the amount of bank lending required, or that they increase pressure on the trade account. Bankers argue that the "risk premium" is necessary to justify further lending to cash-short countries and to keep small and medium-sized "regional" banks in the lending game. Whatever the merits of these arguments, very high profit margins on new loans endanger the borrower's ability to repay, and ultimately can undercut the quality of the banks' developing country loan portfolios. In other words, in certain instances, high "risk premiums" become self-defeating. A flexible approach to the developing country interest rate question may therefore be necessary.

- There are emerging signs that bankers are beginning to address this issue. The banks' recent decision to lower interest costs for Mexico by about one per cent in response to the success of its adjustment program suggests that the interest rate problem can be handled without undue impact on the banks' balance sheets. Regulators and bank analysts should appreciate the important contribution this makes to reducing the debt service burden, which in turn should improve the ability to repay debt.

On the other hand, lowering of interest rates may reduce the incentives needed to keep banks lending. Consequently, some banks have suggested that they would allow some interest payments to be made in local currency, provided there was a guarantee of future convertability into dollars. This could reduce the amount of dollar borrowing required and, most important, would insulate trade credit lines from further reschedulings by making dollars available for imports.

If traders can be assured of the continuity of credit lines, they would be likely to reestablish their own short-term credit. And this would provide additional liquidity to the developing country and to the private firms in the country, adding fuel for a prudent economic recovery.

Official Credits

Governments, too, must continue to contribute to the handling of developing country problems. The depth of current financial problems is clearly too great for private banks to fill the gap by themselves. Nor is it appropriate that they should. Industrial country governments have both interests and responsibilities which make essential their participation in solutions. This means contributing to emergency financing packages for major debtors and aid to smooth the transition to IMF stabilization programs.

The United States has also taken measures to provide developing countries with export credit support. The most prominent actions were two export credit insurance facilities that Eximbank approved in 1983 to Mexico and Brazil for $500 million and $1.5 billion, respectively. An earlier, similar facility in Mexico of about $200 million has proven to be successful in permitting some trade to go forward which otherwise would not have been possible. However, there have been other credit lines extended by both Eximbank and the Commodity Credit Corporation (CCC) over the past 18 months, and some of these are still available.

The World Bank has also given added recognition to the trade finance problem and is now providing short-term trade finance credit under its Export Development Fund.

The U.S. will continue to work to ensure the multilateral character of all of these restructuring efforts. There are, of course, limits to how much of the financing gap can be filled by official creditors. While Exim's insurance and guarantee authority for this fiscal year is $10 billion dollars, U.S. exports to Latin America alone exceeded $20 billion in 1983 and Exim resources are needed to cover sales worldwide.

The Kissinger Commission last week recommended that a special Exim guarantee facility be established for Central America. The President's Task Force for International Private Enterprise is beginning to look at other trade financing proposals. As the costs and risks involved for Exim cannot be overlooked, some of these proposals have recommended that private banks help fund the facility. The Kissinger Commission went further and recommended that only banks who agree to restructure a country's long term debts at the "lowest possible interest rates" should be allowed to access the facility.

Leaving aside the specifics of these proposals, which remain to be assessed in detail by the Administration, above all else they demonstrate the urgency of ensuring adequate foreign exchange for both debt service <u>and</u> for trade. Official and private trade financiers will not reestablish trade lines if hard currency earnings are exhausted to pay interest alone. As developing country debt problems will be with us for some time to come -- <u>establishing a mechanism that would insulate trade credit lines from payment difficulties can reestablish the lifeline needed to help developing country's grow and repay their debt</u>.

The problems in trade finance require a willingness to be bold and innovative. The task is to sort through possible solutions, weighing the merits and debits of each and discarding those which <u>appear</u> to enhance trade, but which probably would merely be encumbering. The caliber of the participants brought together for <u>this conference will help decide which of the "new directions in world trade" stand the best chance of enhancing and supporting the multilateral trade system</u> that has brought more economic development and prosperity to all peoples in the world than any other system in history.

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